IN THE

# United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

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No. 11070.

BYRON C. HANNA,

*Petitioner,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

No. 11071.

DAISY MAY HANNA,

*Petitioner,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

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## PETITIONERS' REPLY BRIEF.

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## TOPICAL INDEX.



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## AUTHORITY CITED.

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### Scope of Reply.

Respondent's Brief endeavors to classify the amounts aggregating $1,168.86, received by Hanna and Morton as interest prior to 1940, in the same category as other items aggregating $5,500, received by Hanna and Morton prior to 1940, and to characterize all of these items, including interest, as compensation "received for personal services" rendered in the employment mentioned in the Opinion of The Tax Court.

In this manner respondent seeks to avoid the definite distinction between the money received as interest and the other items mentioned.

We earnestly believe, as contended in our Opening Brief, that the other items, aggregating $5,500, received by Hanna and Morton prior to 1940, did not constitute compensation "received for personal services rendered" prior to 1940.

However, for the purpose of emphasizing the distinguishing characteristics of the money received as interest, and to clarify the issues, we will direct attention in this Reply Brief solely to the question as to whether that amount constituted part of the compensation "received for personal services rendered" in the employment mentioned.

We do this in the confident belief that upon the record in this case the conclusion is inescapable that this money received as interest did not constitute any part of such compensation.

If that conclusion be accepted, it necessarily follows as a matter of mathematical computation that Petitioners are entitled to avail themselves of the benefit of Section 107, I. R. C.

Respondent proceeds by a series of erroneous premises and deductions to elaborate an argument supporting the contention that the amount received as interest constituted compensation "received for personal services rendered, etc."

Before discussing this final and determinative contention, we note the errors by which respondent approaches it, as follows:

(1) Respondent states:

> "* * * the taxpayer asserts * * * that Section 107 should be given a 'liberal' interpretation which would make its benefits available in a case where the payment on completion of the services is less than the 95% or more required by the statute." (Resp. Br. 9.)

This statement involves two errors:

> *1st.* It is not so much Petitioners' contention that Section 107 should be given a liberal interpretation as that it should be liberally administered and applied.
>
> *2nd.* Petitioners have not contended at any time that it should be given such an interpretation liberally or otherwise as would "make its benefits available in a case where the payment on completion of the services is less than the 95% or more required by the statute."

The question at issue in the present case is whether the "payment on completion of the services" was "less than the 95% or more required by the statute."

(2) Respondent asserts:

> "* * * the taxpayers are not subjected to any penalty by reason of their inability to avail themselves of the special method for computing the tax afforded by Section 107. They are merely placed on the same footing with all other income tax payers whose income is taxed as it is received." (Resp. Br. 9.)

This is a specious and disarming statement. The taxpayers are not "placed on the same footing with all other income tax payers whose income is taxed as it is received." The vast majority of taxpayers receive their income currently for services rendered. It was the recognition of the fact that taxpayers in situations similar to that presented in the present record are penalized and are treated unfairly, that induced Congress to adopt Section 107, and later, in 1942, to extend its operation very substantially.

(3) Respondent argues that:

> "Both the attorneys and the clients recognized that $27,500 was more than enough to cover the anticipated expenses" and that the estimated costs were revealed as excessive in 1933 and 1936 "considering that the total cost paid from 1932 through 1940 was only $14,230.45." (Resp. Br. 11.)

The fact is clearly demonstrated by the record that at the time the employment was accepted by Hanna and Morton, it was entirely impossible to estimate the costs with any degree of certainty or accuracy, and the possible amount of the costs remained equally uncertain until the Supreme Court denied a petition for *certiorari* on January 2, 1940 (304 U. S. 624, 84 L. Ed. 521). Until that time there could be no certainty that the case would not be reversed and remanded for another trial, in which event the costs might greatly have exceeded $27,500. (See testimony of Morton, R. 44, 55-6, 63, and of Hanna, R. 106.)

(4) Respondent asserts:

> "It must also be observed that the clients did not hold the attorneys strictly to their agreement to pay all of the expenses out of the $27,500, because at the termination of the litigation the clients reim-

bursed the attorneys to the extent of $2,429.35 of costs which had been expended from the $27,500 fund." (Resp. Br. 11 and 12.)

In support of this statement, Respondent refers to the portion of the decision of The Tax Court, appearing at page 25 of the record, as follows:

> "Hanna and Morton successfully tried the case for the Lazards, and on January 19, 1940 the Bank paid $746,354.95 in satisfaction of the judgment.
>
> From this amount Hanna and Morton received on that day $114,018.19, consisting of the contingent fee in the amount of $111,588.84 and $2,429.35 reimbursement of costs expended from the $27,500 fund."

Respondent overlooks the fact that the item of $2,429.35 represented taxable costs collected from the bank and which were included in the total amount of the judgment. [R. 97.]

It is therefore clear that there is no foundation for the statement that the clients did not hold the attorneys strictly to their agreement, or for the statement that at the termination of the litigation the clients reimbursed the attorneys to the extent of $2,429.35 of costs which had been expended from the $27,500 fund.

(5) Respondent asserts:

> "Mr. Morton testified [R. 71-72] and the Tax Court found [R. 24] that the interest would have had to be returned, in the same manner as the $5,500 which the taxpayers admit to have been fees (Br. 5), if it ever became necessary to complete the payment of expenses." (Resp. Br. 13.)

The mere fact that the money received as interest was subject to the same conditional obligation of restitution as the $5,500 withdrawn from the trust funds, and which later in 1940 became fees, does not indicate in any manner that the characters of the two types of items were identical.

There is no logical basis for an inference that obligations to be performed in the same manner, arose in the same manner or were founded on the same consideration.

(6) Respondent asserts:

> "The interest so received was currently reported as income by the partners. [R. 24.]" (Resp. Br. 13.)

In support of this statement, Respondent refers to that portion of the decision of The Tax Court appearing at page 24 of the Record, and reading as follows:

> "The interest so received was currently reported as income by Hanna and Morton."

It is true that the interest received was currently reported as income by Hanna and Morton, but this overlooks the important and specific fact that it was not reported as compensation received, but was reported as interest received. [See testimony of Morton, R. 73-4, and Exhibits C, D and E, R. 74-6.]

Immediately following the statement last above quoted from Respondent's Brief, Respondent makes the further statement: "The facts all support treatment of this item as compensation and they permit no inferences to the contrary." (Resp. Br., 13-14.) The complete lack of justification for this statement is disclosed by the specific facts above-mentioned.

**The Sum of $1,168.86 Interest on the Savings Accounts Did Not Constitute Compensation "Received for Personal Services."**

It is established conclusively by the record in this case that the items aggregating $1,168.86, referred to as "interest", were actually received by Hanna and Morton as interest on money deposited in the savings accounts. These items were withdrawn by Hanna and Morton from the banks in which these accounts were carried. They were withdrawn as interest and were not paid by the clients to Hanna and Morton [R. 69-70].

The findings of the Tax Court reflect these facts. Thus, the Tax Court found:

> "A total of $1,168.86 in interest accrued on the savings accounts. During the years 1934 to 1936 Hanna and Morton withdrew this interest for their own unrestricted use having been told by Lang that they could keep it. They were to return it if it ever became necessary to complete the payment of expenses, their obligation in any event being to meet all expenses over the $27,500." [R. 24.]

As hereinbefore set forth, the money so received was currently reported as "interest" income by Hanna and Morton.

There is no question but that the money was received by Hanna and Morton as "interest." The clients granted Hanna and Morton the right to retain and use the interest, subject to the condition that Hanna and Morton would put it back if necessary to complete the payment of expenses [R. 71, 72]. To be precise, the most that respondent can claim is that this grant or authorization to so use this money received as interest constituted additional compensa-

tion to Hanna and Morton for services rendered in the employment mentioned.

There is not a scintilla of evidence in the record to support this contention, or from which a legitimate inference may be drawn to support this contention. Therefore, the further finding of the Tax Court, "This interest was a fee for services when it was so withdrawn by Hanna and Morton" [R. 24-25] is wholly unsupported by the evidence.

The record discloses that during the pendency of the principal case mentioned, Hanna and Morton were employed by the same clients, and also by some of the same clients, under separate and distinct employments to handle other litigation. Thus, they represented certain of the same clients in a stockholders derivative suit on behalf of the Anglo California National Bank of San Francisco against Herbert Fleishhacker [R. 78-79]. They also handled another case, known as "the Market Street case," representing the same clients who were involved in the principal case mentioned [R. 82-83].

From time to time, with the consent of the clients, money was taken temporarily from the trust fund in the principal case to be used for expenses in this other litigation [R. 94.] Therefore, assuming that the granting to Hanna and Morton of the right to make use of the money received as interest constituted compensation to Hanna and Morton, there is no basis for any inference that the compensation was for services rendered in the principal case. In fact, the Tax Court does not find that the interest was a fee for services rendered in the principal case, although the Tax Court does treat it as such in its opinion.

We mention these facts not only for the purpose of showing that there is no evidence to support any finding

that the grant of the right to use this money received as interest constituted compensation to Hanna and Morton for services rendered, but also to show that there is no evidence to support a finding that if it did constitute compensation for services rendered, the compensation was for services rendered in the principal employment mentioned.

The most that can be said for the record is that it shows the following facts: Hanna and Morton were rendering services for the clients under at least three separate and distinct employments; money taken from the trust fund was temporarily used with the consent of the clients, in the payment of expenses in litigation other than the principal case, in connection with which the trust was created; interest accrued on the trust funds; Hanna and Morton withdrew this interest; the clients granted Hanna and Morton the right to use the interest, subject to the obligation to return it if necessary for the payment of costs in the principal case.

At this point, and from this point on, the record is silent. There is nothing to show that the grant of the right to use the interest money was intended by the clients or by Hanna and Morton as compensation for services rendered in any of these matters; or if so, that it was intended as compensation for services rendered in the principal case. There are, however, in the record definite indications that the granting of the right to Hanna and Morton to make use of the interest money did not constitute additional compensation in the principal case. The amount of money involved in that case, the voluminous legal services contemplated in the employment in that case, the amount of the fee which the clients had agreed to pay in the event of success in that case, the fact that the compensation of the attorneys in that case was definitely fixed by a written con-

tract of employment, all constitute circumstances which refute any suggestion that the granting of the right to make use of the sum of $1,168.86, received by Hanna and Morton as interest, was additional compensation for services to be rendered in the case.

Moreover, the fact that the total fee in the principal case, exclusive of this amount of $1,168.86, amounted to a sum in excess of $120,000, characterizes any such suggestion as an absurdity. In view of all the circumstances surrounding the clients and Hanna and Morton in connection with this litigation, the amount involved in the litigation, and the nature and extent of the services required, if any additional compensation had been paid by the clients to Hanna and Morton, it is reasonable to expect that such additional compensation would have been comparatively substantial.

Measured against this background, the amount of $1,168.86 is so trifling as to stamp as inconceivable any idea that it constituted additional compensation for services rendered in the principal employment.

Additionally, it should be observed that at the time each of the amounts aggregating $5,500 was withdrawn by Hanna and Morton, with the consent of the clients, from the trust fund prior to 1940, entries were made in the books of Hanna and Morton indicating that the amounts so withdrawn were in the nature of conditional payments on account of fees [Ex. 5, R. 49 and 50; Ex. 6, R. 50; Ex. 7, R. 50-51; Ex. 8, R. 51-2; Ex. 9, R. 52].

There is no evidence that the amounts received as interest, aggregating $1,168.86, were ever so treated or characterized on the books of Hanna and Morton. In fact, there is no evidence that such amounts were ever credited or treated by Hanna and Morton as payments on account of compensation for services rendered in the principal case, or otherwise.

## Conclusion.

For the reasons set forth in our Opening Brief, as well as in this Brief, the decision of The Tax Court should be reversed.

Respectfully submitted,

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